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FEDERAL COMMUNICATIONS COMMISSION
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December 10, 1993

Mr. William F. Caton
Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, DC 20554

Re: CC Docket No. 93-251, Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions Between Carriers and Their Nonregulated Affiliates.

Dear Mr. Caton:

Enclosed herewith for filing are the original and four (4) copies of MCI Telecommunications Corporation's Comments in the above-captioned proceeding.

Please acknowledge receipt by affixing an appropriate notation on the copy of the MCI Comments furnished for such purpose and remit same to the bearer.

Sincerely yours,

Elizabeth Dickerson

Elizabeth Dickerson
Manager, Federal Regulatory

Enclosure
ED/ms

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20054

In the Matter of	)	
	)	
Amendment of Parts 32 and 64 of	)	
the Commission's Rules to Account	)	CC Docket No. 93-251
for Transactions between Carriers	)	
and Their Nonregulated Affiliates	)	

COMMENTS OF MCI TELECOMMUNICATIONS CORPORATION

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SUMMARY

The FCC's present mix of affiliate transaction valuation methods falls short of protecting ratepayers against cross-subsidization and MCI supports adoption of the aggressive rules the Commission proposes. It believes that the current reliance on prevailing company pricing should be discontinued, except in the limited circumstances the Commission delineates (when the carrier meets a test showing its primary purpose is not to supply its regulated affiliate). Further, MCI supports the rate base methodology the Commission contemplates, except that the rate of return should be calculated at the low end of any ranges the Commission's alternative regulatory schemes provide. MCI also supports the Commission's proposed change in the valuation methodology for services (at the lower of cost or FMV for those provided to the regulated entity and at the higher of cost or FMV for those the regulated entity provides).

MCI believes that any underlying cost changes resulting from modifications to valuation methodologies should be afforded exogenous treatment, and the CAMs and audit procedures should be modified to accommodate these rule changes.

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In the Matter of Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates	))))))	CC Docket No. 93-251

COMMENTS

MCI Telecommunications Corporation ("MCI") hereby submits its comments in response to the Notice of Proposed Rulemaking ("NPRM") filed by the Commission on October 20, 1993, in the above-captioned proceeding. In the NPRM the Commission proposes a number of amendments to Parts 32 and 64 of its rules that would modify the methodology the local exchange carriers ("LECs") employ in valuing transactions between them and their nonregulated affiliates.

I. Introduction.

MCI applauds the initiative in this rulemaking because it provides long overdue refinement and tightening of accounting rules in an area that historically has been subject to considerable carrier abuse. It is critical that the exchange of services and products among corporate affiliates subject to varying degrees of regulation be closely monitored to prevent cross-subsidization of nonregulated ventures by regulated ratepayers. Even in the price cap environment, the incentives and opportunities to engage in cross-subsidization continue to flourish. This is because, absent stringent affiliate transaction costing rules, carriers can readily increase the apparent costs of input for regulated services, thereby either avoiding sharing at the upper end of the earnings range or, if they are earning near the bottom end, triggering the lower formula adjustment mechanism. Either way, captive ratepayers are forced to pay an inflated price for goods and services that are available solely from the LECs.

MCI supports efforts to increase the scrutiny of accounting rules, enhance their effectiveness, and expand carrier monitoring requirements. The Commission's current endeavors in this regard are supported by a recent GAO study has shown that the recent independent and FCC on-site audits of the carriers' cost allocation practices have been ineffective in detecting carrier abuses.[1] This finding supports the Commission's efforts to establish a better means of measuring and monitoring the valuation of transactions between regulated carriers and their nonregulated affiliates in order to place the focus on prevention, rather than detection of carrier transgressions.

II. The Commission Should Adopt its Proposed Valuation Methods for Affiliate Transactions.

The Commission correctly recognizes that regulated entities should realize cost savings when dealing with nonregulated affiliates: lower transactions

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[1] Telephone Cross-Subsidy, GAO/RCED-93-34, Released February 3, 1993, p. 7. (This study evaluated the FCC's ability to oversee various LEC audit areas, including affiliate transactions.)

costs, a lower earnings component associated with lower business risk, and economies resulting from guaranteed market for products or services. (NPRM, at para. 18) These promised savings (as well as those economies intended to accrue by foregoing structural safeguards), however, are jeopardized by the countervailing impact of potentially inflated prices for the regulated operation that current rules permit.

So that FCC resources do not have to be squandered on detecting after-the-fact abuses of its rules, MCI encourages the adoption of the proposed rules that will minimize the risk of such infractions ever occurring. Thus, MCI agrees with the Commission that the present mix of affiliate transaction methods falls short of protecting ratepayers against cross-subsidization (NPRM, at para. 9) and supports adoption of the rule amendments the Commission proposes. Also, use of prevailing company pricing should limited to the circumstances the Commission delineates. Further, MCI supports the rate base methodology the Commission contemplates, with minor modifications. Finally, MCI encourages the Commission to adopt, for services, a pricing model that establishes net book value as a floor or ceiling, depending on the direction of the exchange between regulated and non-regulated affiliates.

The current rules allow regulated LECs to follow a valuation hierarchy that permits carriers to book transactions with affiliates at tariffed rates, net book costs, fully distributed costs, prevailing company prices, or estimated fair market value. MCI shares the Commission's concern that it is inappropriate to allow prevailing company pricing when the nonregulated affiliates have a primary purpose to serve the carrier and other affiliates. (NPRM, at para. 19) This is because the nature of the relationships between LECs and their nonregulated affiliates does not represent the sort of arm's length transactions that in an open market would provide a reliable measure of the price of the transactions. Under the current circumstances, there are no firm guidelines that ensure that the price recorded on the books of either entity engaged in a transaction has any relation to either the professed market price or to its underlying cost. If a nonregulated affiliate over-estimates the prices of goods or services, the nonregulated affiliate can record a greater-than-actual profit on its books. Similarly, the regulated operation can use its increased costs, as noted above, to manipulate the sharing mechanism of price caps. Alternatively, those carriers still regulated under the rate-of-return rules can simply increase their overall profits by collecting their authorized rate of return on expenses that are in excess of what are reasonable and necessary. These opportunities for carriers to manipulate the rates they charge regulated ratepayers by misstating the prices of transactions with nonregulated affiliates render these transactions sufficiently different from transactions among nonaffiliates to justify the Commission's curtailment of the rules' reliance on the prevailing company pricing standard of valuation.

Under the current rules, the carriers have virtually total control over their claimed levels of prevailing company prices, and the incentive exists for them to select prices that inflate total company earnings at the expense of the regulated ratepayers. This perpetual conflict between the ratepayers' interests and the shareholders' interests supports elimination of the unchecked use of prevailing company pricing because there is no incentive or rules that require such conflict to ever be resolved in favor of (or, at least, without harming) the ratepayer. This is particularly true, as the Commission recognizes (NPRM, at para. 19) for those nonregulated affiliates whose primary purpose is to serve the carrier and its other affiliates.

Prevailing company pricing, however, continues to have a role in affiliate transaction valuation. When there is some degree of assurance that the prices the carrier claims are indeed accurate representations of true market prices, prevailing company pricing is appropriate. The Commission correctly recognizes, however, that there must be a bright-line test to make such a determination. The Commission proposes a standard whereby 75% of a nonregulated affiliate's revenues must be obtained through third party sales in order to establish that its primary purpose is not to serve its regulated affiliates. MCI agrees that such a standard is necessary to ensure that the stated prevailing company prices result from use of a reasonable valuation method. MCI urges the Commission to adopt its proposed 75 percent threshold. There is no scientific way to identify the actual percentage of sales at which the necessary degree of assurance of veracity is reached, so any level selected necessarily will be somewhat arbitrary. However, the level chosen -- almost by definition -- must be greater than fifty percent in order for the pricing to qualify as "prevailing." On the other hand, the level cannot be as great as one hundred percent, or there would be no affiliate transactions to consider. Because any number within this range is as arbitrary as the next, MCI suggests that "splitting the difference" offers an equitable solution.[2]

Unless prevailing company pricing can be restricted to only those instances where it is appropriate -- that is, unless a workable test can be implemented -- it should be abandoned altogether as a means of valuation. Simply put, the presumption should be against allowing prevailing company pricing unless the entities who designate the corporate structure and pricing can convincingly assure ratepayers and regulators that the prices they charge are representative of true market pricing. The Commission's 75% test sets a high enough standard that, by meeting the test, carriers appropriately assume the burden of demonstrating the validity of the claimed prevailing company prices.[3]

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[2] Any other logic demands more precise statistical analyses. MCI contends that the nature of the problem -- identifying a level at which the LECs are truthfully setting prices -- precludes such analysis. Since LECs would necessarily stand behind the veracity of their prevailing prices, there are no data available to support or repudiate any assertions that prevailing prices are misstated.

[3] Acceptance of this test as adequate is based on the premise that the Commission will adopt either a product-by-product or product line measure of revenues. Otherwise, a much higher percentage would be necessary.

Under the current rules, assets are transferred between regulated and nonregulated entities in the following manner: (1) for assets transferred to the regulated entity, they must be valued at the lower of cost or fair market value; and (2) for assets transferred to the nonregulated entity, they must be valued at the higher of cost or fair market value. MCI supports retention of these valuation rules for asset transfers and encourages the Commission to extend this methodology to services valuations as well. (NPRM, at para. 24) This is because MCI agrees with the Commission's analysis of the present valuation methods for affiliate services in that they "reward imprudent carrier conduct [... by] motivating carriers to sell services for less than fair market value." (NPRM, at para. 32) If LECs sell services to nonregulated affiliates for less than fair market value, they damage their ratepayers twice: first, through discriminatorily inflated prices; and further, by manipulating their earnings so as to exploit the sharing mechanism (or otherwise inflate earnings, in a rate-of-return environment). Any time captive ratepayers are forced to pay more than fair market value for services from nonregulated affiliates, it results in imprudent inflation of monopoly prices. Again, it is the LECs' stockholders who benefit at the expense of captive ratepayers by receiving a higher return on the nonregulated operations than would be attainable without the existence of such subsidies. It is necessary to adopt strict valuation restraints to eliminate the potential for reenactment of the classic "heads, shareholders win; tails, ratepayers lose" scenario.

III. Changes in Valuation Methodologies Should Be Subject To Exogenous Treatment.

MCI strongly supports the Commission's conclusion that any changes in the valuation methods should be afforded exogenous treatment. First of all, the proposed rule changes are discretely identified by the Commission as one of the events that qualifies for exogenous treatment.[4] Further, unless exogenous treatment is mandated, LECs will continue to benefit from having overstated (at the time price caps were initialized), the cost of inputs acquired from nonregulated affiliates. To the extent that current prices are based on inflated valuations of inputs provided by affiliates, any savings from correcting the valuation methods should accrue directly to the ratepayer. While exogenous treatment would similarly pass any resulting increases in rates to the ratepayer, MCI does not believe that this is likely to happen. Since there has been no incentives historically for carriers to abuse the valuation rules by understating the cost of goods and services provided by nonregulated affiliates.

IV. The Commission Should Adopt Its Proposed Rate Base Methodology.

MCI supports the Commission's decision to establish a rate base methodology for costing the inputs to the regulated products and services that originate in a nonregulated operation. Without requiring costs to be calculated under the same assumptions the Commission historically has required for the regulated interstate rates, carriers could manipulate their costing structures

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[4] 47 C.F.R. § 61.45(d).

through variations in their corporate structures. The Commission is correct in noting that there is nothing preventing carriers from designing their corporate structures so that a LEC could obtain virtually all of its regulated resources from an affiliate. (NPRM, at para. 42) By adopting these proposed rules, the Commission can appropriately leave to the corporation its decisions on overall structure, yet maintain the necessary degree of oversight of a carrier's regulated costs. Such an approach is especially valid since it would apply primarily to those "affiliates that have serving carriers and other affiliates as a primary purpose." (NPRM, at para. 42) The costs of the products and services obtained from nonregulated affiliates, therefore, should be calculated incorporating the generic rate base methodology the Commission recommends, using the modifications necessary to replicate the assumptions (regarding such items as construction in progress and noncurrent assets) that characterize traditional telecommunications rate-of-return methodologies.

MCI contends, however, that the rate-of-return on which non-regulated affiliates should base their rate-base calculations should be set at the lowest point of any range that the Commission allows under its alternative regulatory plans. That is, traditional rate-of-return carriers should use the current single point 11.25 authorized return. Price cap carriers should be subject to the 10.25% point in their range. Those carriers subject to optional incentive regulation should target their cost calculations to earn 75 basis points below the rate-of-return prescribed for interstate services, or 10.50%.

Allowing the carriers to earn at the top end of permissible ranges creates perverse incentives that ultimately will harm the ratepayers. This is because guaranteeing non-regulated entities a rate-of-return on the high end of the ranges will discourage LECs from attempting to achieve the 75% benchmark that entitles them to use prevailing company pricing, thereby depriving ratepayers of the benefit of acquiring necessary inputs at competitive prices.

Not only is there is no harm to the non-regulated affiliates by setting their earnings at the low end of the range, but there is considerable justification for doing so. First of all, the low end of the range falls within the Commission's "zone of reasonableness."[5] That is, it represents an earnings level below which the Commission would not recognize a need to raise rates even for fully regulated affiliates. Further, the lower the risk an entity faces, the lower the necessary return. As the Commission notes, the "affiliate relationship reduces the supplier's business risks," (NPRM, at para. 18), supporting adoption of a return at the lower end of the range.

Also, there is no viable argument that non-regulated goods and services would even be able to earn the upper level in a fully competitive market. The mix of goods and services that the carriers obtain from their non-regulated entities is so diverse that it is impossible to make a cursory determination of

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[5] Represcribing the Authorized Rates of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, 5 FCC Rcd 197, 201 (1990), citing FPC v. Natural Gas Pipeline Co., U.S. 575, 585 (1942); Permian Basin Area Rate Case, 390 U.S. 747, 767 (1968).

what rate-of-return they would achieve absent their captive regulated purchasers.

Further, the range was set under entirely different financial circumstances than exist today, and current economic conditions would not support such a high return. For example, in December 1989, the month during which the Commission prescribed the 11.25% which marks the top of the price cap carriers' earning range, the yield of six month Treasury Bills was 7.45%.[6] By contrast, today the same security earns only 3.32%.[7] Even though "interest rates cannot be used to calculate just and reasonable rates-of-return in any simple fashion," the Commission previously has recognized that "they do serve as indicators of trends in equity capital costs,"[8] and an analysis of Treasury Bills can be used as a perfunctory indicator of appropriate earnings levels.

Perhaps even more important, the Commission has recognized that investment in infrastructure may represent a risk that should be reflected in a carrier's authorized return.[9] Since non-regulated entities do not have similar capital requirements, every effort should be made to eliminate that unnecessary component from their authorized return.

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[6] Economic Report of the President, United States Government Printing Office, Washington, D.C., February 1992, p. 379.

[7] Wall Street Journal, December 10, 1993, p. C16.

[8] Represcribing the Authorized Rates of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, 5 FCC Rcd 197, 202 (1990).

[9] Id.

Finally, if the carriers wish to be guaranteed earnings at the high end of the range, their control over their corporate structure certainly would permit them to move the product line in question into the regulated entity.

Regulated ratepayers, however, will benefit most if the goods and services they obtain for input into their regulated goods and services are procured in a competitive market. This is because prices in a competitive market move towards costs, and competitive prices should theoretically represent the most efficient provision of any good or service. If the Commission allows carriers to use the high end of the range as the earnings component in their non-affiliate rate base calculation, they will lose the efficiency incentive. This is because, under the Commission's proposal, the companies could achieve a guaranteed 11.25% rate-of-return for those situations where the nonregulated affiliate sells between 0 and 74.99% of nontariffed goods and services to nonaffiliated entities -- without the risks associated with operating in a competitive market. Setting the rate at the lower end of the removes some of the incentive for carriers not to market more aggressively their non-regulated goods and services to non-affiliates. It is to the benefit of regulated ratepayers for the companies to achieve the 75% benchmark that entitles them to use prevailing company pricing because only then are the goods and services procurable at truly competitive prices.

V. The Prevailing Company Pricing Test Should Be Applied on a Product Line Basis.

The Commission invites comment on whether it should provide for prevailing company pricing on a product-by-product, product line, line of business, or total company basis. Holding companies theoretically have total control over both their affiliate structures and the product mix that each one offers. The less disaggregated an option the Commission adopts, the greater the chance that the company can game the system. That is, the more diverse the mix of products reviewed, the greater the opportunity the company has to combine those for which it seeks cross-subsidization with those that can satisfy the 75% criterion.

The Commission should reject the total company basis and line of business basis because they would allow the company to compare disparate products for purposes of determining whether the distribution of certain of these products to third parties could be used as a benchmark for setting market prices. Because the company has total control over establishing the composition of lines of businesses, both the total company approach and the line of business approach likely would result in product and service mixes where the pricing of any individual service could have no relation to the pricing of the others, effectively rendering completely meaningless the 75% test.

Any test the Commission adopts should ensure that market pricing estimates of the companies reflect true market value. If diverse products and services are commingled, however, they will represent different markets altogether. The pricing of a particular service in a distinct market niche likely will have no bearing on whether the company's estimation of market value of another service is accurate. For example, a supply company could provide a minimal number of switches to third parties, yet the cost of the switches could weight the "revenue basket" heavily enough to establish the right to prevailing company pricing for the other services therein. The problem is that this method lacks any regard for the actual market value of these other services.

The best way to avoid this phenomena altogether is to measure fair market value on an apples for apples basis -- that is, on a product-specific basis. This would enable an accurate audit of whether a product or service was valued at the same level that it is offered to the general public (measured by the 75% threshold). This would eliminate the need to contemplate whether the market basket the company offered for determining prevailing company pricing actually reflected services and products, the prices for which bore some relation to the market value the company claimed.

MCI recognizes, however, that although the most accurate results would be achieved through this method, the burden of complying with it might be too onerous. Alternatively, MCI urges the Commission to adopt the product-line approach. This would ensure that similar products are grouped together, thereby allowing a meaningful analysis of the different valuation levels assigned to the items in the basket. Under this approach, a supply company would be able to value the switches it procures for its own telephone company operations at prevailing company prices only if it meets the 75% test for all switching products. An analysis of incremental differences in switch prices would be more meaningful than an analysis of switch prices compared to all miscellaneous supplies (as would be the case under the total company or line of business approaches). This is because it is likely that the markups on large capital items are different than on commodity items, but that the markups on similar capital items are similar (or that the markups on similar commodity items would be similar). As long as a pricing basket contains items the prices for which are set using unrelated theories (i.e., decisions on how much to markup the cost), a guarantee that the prevailing company pricing of one type of item is accurate offers no similar assurance for the other components of the basket. On the other hand, while markups might vary among switches based on capacity and options, they would tend to be in a similar range, and a cursory analysis of switching prices would suffice to identify any outlying valuation estimates. Since the product line approach offers the best balance between carrier burden and meaningful analysis, MCI urges the Commission to adopt that method.

VI. The Commission Should Require a Detailed Showing of the LECs' Estimate of Fair Market Value For Certain Types of Transactions.

MCI is concerned that the Commission's proposal for allowing carriers to make good faith estimates of fair market value for comparison with cost (based on the rate base methodology) for those nontariffed transactions for which prevailing company pricing is not allowed provides the carriers with too much leeway and pricing flexibility. While MCI agrees that the range of products and services is so extensive that it would be impossible to specify a step-by-step approach to valuation, it also believes that a greater showing should be required by carriers who rely on fair market value in certain circumstances.

The Commission proposes to require carriers to "make additional efforts to define" a transaction's fair market value. (NPRM, at para. 90) While the Commission appropriately requires carriers to use "cost" as a floor or a ceiling (depending upon the direction of the transaction), this rule results in appropriate transfer prices only if the carriers make good faith estimates of the fair market value of the assets. For example, if a LEC is transferring land and buildings to its nonregulated affiliate, the Commission's permissive guidelines could result in the transfer being booked at cost -- the designated floor for such a transaction -- despite significant appreciation of the asset. Because it would be advantageous to the holding company for the LEC to transfer this asset at cost, the incentive exists for the carrier to underestimate fair market value. Arguably, the resources necessary to evaluate each carrier's fair market valuation would be enormous and the Commission has indicated it might not be feasible to adopt a step-by-step approach for such valuations.

At a minimum, therefore, the Commission should require carriers to make more specific showings for valuations of certain magnitudes and certain types of transactions. For example, the Commission might require greater scrutiny of transactions that fall into any of the following categories: (1) single item transactions that exceed $100,000; (2) multiple item transactions that exceed $250,000; (3) items transferred to the LEC where FMV is estimated at more than twice the initial cost; (4) items transferred from the LEC where FMV is estimated at less than half the initial cost; or (5) products or services whose prices deviate more than 5% from the prices charged to nonaffiliates. Any number of other measures might also be used to flag those transactions for which the company sets a fair market value but the valuations of which, by their nature, should require increased scrutiny.

VII. The Commission Should Require Enhancements to the Carriers' Cost Allocation Manuals and Audit Requirements.

MCI strongly supports the Commission's planned enhancements to the carriers' cost allocation manuals ("CAMs"). Since the CAMs provide a crucial tool for analyzing costs claimed for regulated operations. The associated impact of affiliate transactions can be better understood if the operations of all affiliates who fall under these Commission rules -- and not just those who share resources with regulated operations -- are highlighted in the CAM. Further, if the Commission adopts its 75% test, it is imperative that the carriers identify which of their affiliates meet the test. Depending upon which measure of the test the Commission approves, it may be necessary that the carriers also identify those product lines that meet the test. MCI agrees that any rate of return other than a prescribed one must be identified, and the CAMs should include any procedures the carriers use for estimating fair market value.

Finally, MCI concurs with the Commission's proposed changes to the audit rules: the independent audit must encompass compliance with these new rules and an audit trail requirement should be incorporated into the rules.

VIII. Conclusion

For the foregoing reasons, MCI urges the Commission to adopt its proposed rule changes, subject to the MCI's recommended modifications.

Respectfully submitted,

MCI TELECOMMUNICATIONS CORPORATION

Elizabeth Dickerson

Elizabeth Dickerson
Manager, Federal Regulatory
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(202) 887-3821

December 10, 1993

STATEMENT OF VERIFICATION

I have read the foregoing and, to the best of my knowledge, information, and belief, there is good ground to support it, and it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on December 10, 1993.

Elizabeth Dickerson

Elizabeth Dickerson
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(202) 887-3821

CERTIFICATE OF SERVICE

I, Susan Travis, do hereby certify that copies of the foregoing MCI's Comments were sent via first class mail, postage paid, to the following on this 10th day of December 1993:

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